SUPREME COURT, U. S.

No. 791

FILED

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IN THE

# Supreme Court of the United States

OCTOBER TERM, 1970

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BERNARD P. McDONOUGH,

*Petitioner,*

—v.—

JOHN BERSHAD,

*Respondent.*

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## BRIEF OF RESPONDENT JOHN BERSHAD IN OPPOSITION TO PETITION FOR A WRIT OF CERTIORARI

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### Counter Statement of Questions Presented

1. Whether in granting summary judgment, the Court below properly took judicial notice of facts validating jurisdiction to entertain a suit under Section 16(b) of the Securities Exchange Act of 1934?

2. Whether in granting summary judgment the Courts below were in conflict with prior rulings of this Court or other Courts?

3. Whether the Courts below in granting summary judgment properly imposed liability under Section 16(b) of the Securities Exchange Act of 1934 against Bernard McDonough on principles of constructive ownership for a prohibited sale or disposition effected by him not only for himself but for his wife while acting as her attorney in fact?

4. Whether the decision of the Court below constituted such an unsanctioned departure from the accepted and usual course of judicial proceedings as to require the exercise of this Court's power of supervision?

## Statutes Involved

Petitioner has set forth Section 16(b) of the Securities Exchange Act of 1934 [15 U.S.C. 78(p)(b)], but has neglected to set forth the following relevant material:

Securities Exchange Act of 1934, Section 3(a) (13) and (14), 15 U.S.C. 78(c)(a) (13) and (14):

> "(13) The terms 'buy' and 'purchase' each include any contract to buy, purchase or otherwise acquire."
>
> "(14) The terms 'sale' and 'sell' each include any contract to sell or otherwise dispose of."

SEC Release No. 34-7793, January 19, 1966, 31 FR. 1005:

> "• • • •
>
> "Generally a person is regarded as the beneficial owner of securities held in the name of his or her spouse and their minor children. Absent special circumstances such relationship ordinarily results in such person obtaining benefits substantially equivalent to ownership, e.g., application of the income derived from such securities to maintain a common home, to meet obligations which such person otherwise would meet from other sources, or the ability to exercise a controlling influence over the purchase, sale, or voting of such securities. • • • "

## Counter Statement of the Case

At all relevant times, Cudahy Company ("Cudahy") common stock was listed and traded on the New York Stock Exchange (14a, 15a).* McDonough and his wife each purchased 141,363 shares of Cudahy common stock on March 15 and 16, 1967, at $6.75 per share (16a, 26a). Together they owned in excess of 10% of the outstanding common stock of Cudahy (21a, 22a, Respondent's Appendix 1 (p. 15 *infra*)).** Immediately after the purchase McDonough was made an officer and elected a director and Chairman of the Board of Cudahy (16a). In addition, Donald E. Martin and Carl Broughton, business associates of McDonough were elected to the Board (38a, 39a). It is obvious from the foregoing and the subsequent assumption of control by United States Smelting Refining and Mining Company ("Smelting") following the so-called "Option Agreement" between Smelting and the McDonoughs, that the block of 282,726 shares owned by the McDonoughs constituted the controlling block of shares of Cudahy, sufficient to dictate the foregoing elections of directors.

In July, 1967, less than six months after the McDonoughs' purchase, Smelting wished to acquire and McDonough to dispose of his controlling block of said Cudahy shares. This involved a profit to the McDonoughs of $612,000.00 (15a, 30a).

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* References in parentheses followed by lower case "a" are to pages of the record before the Court below; references to Appendix A or B are to the Appendices in the Petition and references to Respondent's Appendix are to pages attached to this brief.

** S.E.C. Form 3, filed by United States Smelting Refining and Mining Company which was an exhibit to the deposition of Jack Wilder, part of the Record on Appeal, referred to in the order and judgment (3a) (Appendix A) and on file in the Circuit Court (cf. *Chapman* v. *Rudd Paint & Varnish Corp.*, 409 F.2d 635, 638 (9th Cir. 1969)).

An outright sale by the McDonoughs would have been on its face a violation of Section 16(b) and would have subjected them to short term capital gains treatment (Int. Rev. Code § 1223, 26 U.S.C. 1223).

The parties entered into the following arrangement:

(a) An agreement labelled an "option" to buy 272,000 shares was entered into on July 20, 1967. Smelting was to pay the McDonoughs $330,000.00 as a down payment to be applied as a credit against the total purchase price of $2,448,000 if the sale was completed on or before October 1, 1967 (30a, 31a). This down payment constituted 14.3% of the total purchase price.

(b) An irrevocable proxy to vote the 272,000 shares at any regular or special meeting of Cudahy stockholders was executed and delivered to Smelting by the McDonoughs on July 20, 1967 (33a).

(c) 272,000 shares of the McDonoughs' Cudahy common stock were placed in escrow on or about July 27, 1967 (32a, 42a).

(d) McDonough agreed that since Smelting now had the "option", he and one other person would resign from the Cudahy board (29a, 57a).

(e) Smelting, in voting control of Cudahy by virtue of the combination of the "option" and the irrevocable proxy, on or about July 30, 1967, caused the then Cudahy management and board to elect five nominees of Smelting to the Cudahy board by serial election (i.e. without waiting for or calling a special meeting of the Cudahy stockholders (58a, 63a, 64a)). The Cudahy Board was thus placed under the control of Smelting.

(f) On or about July 20, 1967, Smelting filed with the Securities and Exchange Commission, SEC Form 3 "Initial Statement of Beneficial Ownership of Securities", Respondent's Appendix 1 (p. 15 *infra*) required by Section 16(a) of the Act to be filed by every person who "is directly or indirectly the beneficial owner of more than 10 percentum of any class of any equity security . . . within ten days after he becomes such beneficial owner". 15 U.S.C. 78p(a).

Payment of the balance of the purchase price took place on September 27, 1968 (42a).

The Courts below have both found as a matter of law that the facade of "option" (with later exercise after the six months statutory period had elapsed) so carefully erected by the parties, was illusory, and that there had taken place in July 1967 an actual transfer of all beneficial economic interest in the Cudahy stock proscribed by Section 16(b) of the Act. The Opinions below (Appendix A and B) indicate that the basic realities were the 14.3% down payment of $350,000, the practical improbability that it would be forfeited by Smelting's failure to complete the purchase, McDonough's recognition of this improbability as evidenced by the grant of the irrevocable proxy, the resignations of McDonough and Broughton, the concomitant divestment of McDonough's control over Cudahy and the vesting in, and untrammeled exercise of, such control by Smelting (12a). The fact that the balance of the selling price was to be paid thereafter was deemed to be of no consequence.

We submit that the statement of the case by the Petitioner is incomplete. At page 6 the Petition recites that when the McDonoughs purchased their stock in Cudahy, Mr. McDonough was elected to the board of directors. It

is not stated that he used this acquired stock to effect not only his election but the election of two of his business associates (Appendix B, page 30).

It begs the question when it states that:

> "The evidence was uncontradicted that the parties intended to execute an option."

The parties intended only a purported option.

Further, in his description of what took place after the escrow agreement was executed and the irrevocable proxy granted to Smelting, Petitioner neglected to indicate that he and one of his associates resigned as directors and that with the irrevocable proxy in its hands, Smelting utilized the control inherent in the block of stock to require the then Cudahy board to elect via serial voting five officers and directors of Smelting to the Cudahy board who then constituted a majority of the Cudahy board. Petitioner thus omitted the key fact that immediately after the "option" Smelting had control of Cudahy, and the right to change its financing arrangements, its organization and management policies and cause it to enter into business transactions along whatever lines Smelting wished (Appendix A, page 21; Appendix B, page 31).

More significantly, nowhere in petitioner's statement of the case does he recite a key fact, namely, that Alma McDonough was his wife and that the initial purchase was handled by him without her presence and that the "option" agreements themselves were handled entirely by him without her participation, and that after all the terms were set he merely called upon her to sign the papers. (Respondent's Appendix 2, p. 16 *infra*—Excerpt from Depositions of Jack Wilder, President of Smelting.)

The District Court granted plaintiffs cross-motion for summary judgment and denied defendants' motion for summary judgment (Appendix A). The Circuit Court affirmed the District Court's decision and held that the transaction was a prohibited one within the meaning of Section 16(b) of the Act and ruled that a "sale", or "contract to sell or otherwise dispose of" was effectively accomplished within the six month period contemplated by Section 16(b) (Appendix B).

## Reasons for Denying the Writ

The decisions of the Courts below present no novel questions of law, but merely a realistic application of the law to a particular set of facts. In essence, the Court held that a "sale" or "contract to sell, or otherwise dispose of" stock within the meaning of Section 16(b), would be found even though the parties used the label of an "option", where the seller in fact transferred the entire package of jural rights inherent in stock ownership and where the seller received a down payment of $350,000, more than 14% of the purchase price, which was to be credited against the ultimate purchase price and forfeited if the so-called option was not picked up. This was so substantial a portion of the purchase price as to negate any reasonable probability that the purchaser would not pick up the stock and pay the balance. The court's holding that McDonough was liable for his wife's purchase and sale within the prohibited six month period was merely an affirmation of the principles expressed in an interpretive release adopted by the SEC (SEC Release No. 34-7793, January 19, 1966, 31 F.R. 1005) and applied the public policy underlying the Act to the realities of the transaction constructed by McDonough.

The decision below struck down the so-called option as a device in evasion of the law. No such new departure from the law was made by the said ruling to require the intervention of this Court.

**1. Petitioner's argument that Respondent did not allege or prove demand on Cudahy, rejection thereof or a 60 day interval, has no merit.**

Respondent was not required to allege demand and rejection or inaction since he did allege that demand was unnecessary and would be futile (complaint ¶ 21, 23a). *Berkwich* v. *Mencher*, 239 F.Supp. 782 (D.C.N.Y. 1965); *Netter* v. *Ashland Paper*, 19 F.R.D. 539 (S.D.N.Y. 1956); *Grossman* v. *Young*, 72 F.Supp. 375 (D.C.N.Y., 1947); *Blau* v. *Ogsbury*, 210 F.2d 428 (2nd Cir. 1954). The issue could not be raised by McDonough, the profiting insider, but only by Cudahy, the issuer (*Grossman* v. *Young*, *supra*). Further, the courts below properly took judicial notice of prior litigations involving the same defendants (*Abrams* v. *McDonough and Cudahy Company*, CCH Fed. Sec. L. Rep. 1967-69 Dec. para. 92,271; *Silverman* v. *McDonough and Cudahy Co.*, CCH Fed. Sec. L. Rep. 1967-69 Dec., para. 92,285) in which suits on the same theory had been dismissed for lack of jurisdiction in New York. In addition, a proxy statement of Cudahy dated October 3, 1968 referred to these two lawsuits (Respondent's Appendix 3 p. 17 *infra*). This was a clear acknowledgment that Cudahy's management was aware of the claims and had failed to commence action. The Circuit Court correctly took judicial notice of the foregoing and used the same to affirm the decision of the court below *Shuttlesworth* v. *City of Birmingham*, 394 U.S. 147 (1968); *Kamsler* v. *M.F.J.*

*Corporation*, 359 F.2d 752 (7th Circuit); *Wagner* v. *Fawcett Publications*, 307 F.2d 409 (7th Circuit) Cert. den. 372 U.S. 909; 5 *Moore's Federal Practice* (2d ed.) p. 1369 paragraph 43.09.

**2. The decision below does not conflict with prior decisions of this Court or other courts.**

Petitioner's citation of *Blau* v. *Lehman*, 368 U.S. 403 (1962) and the cases at page 12 of the Petition dealing with true options have no relevance and the arguments of Petitioner at pages 12 to 14 completely miss the point. The courts below very properly refused to permit McDonough to utilize the "option" label to argue that the labelling itself creates an issue of fact and thus validates what the defendant did. This was not a true option. Smelting could have investigated the affairs of Cudahy without having five men elected to the board of Cudahy and taking complete control of its operations and activities. The transaction involved more than a mere "call" on Cudahy's stock. The example of the call is far out of point since in the typical call the amount paid would be a premium in excess of the purchase price and not a credit against the purchase price. Contrary to the petitioner's arguments at page 13, *Blau* v. *Allen*, 163 F.Supp. 702 (S.D.N.Y. 1958) teaches that an alleged option with a down payment of 11% of the purchase price could constitute a sale or contract to sell or dispose. In the instant case the courts below correctly held that adding the irrevocable proxies the resignations and the seizure of control of Cudahy by Smelting to the 14% down payment required summary judgment for the plaintiff. A decision to the contrary would open a wide door for escape from the provisions of Section 16(b) against insider trading.

It is interesting to note that the "acid test" suggested by Petitioner at p. 13 would admittedly sanction transactions in which a purchaser could pay $900,000 of a total price of $1,000,000 and claim that the transaction was not within 16(b) so long as the transaction was called an "option". Petitioner's approach would open an avenue for the evasion of Section 16(b).

Petitioner's argument that interest was improper has no merit. If he violated Section 16(b), he used the illegal profits and deprived Cudahy thereof. *Perfect Photo, Inc.* v. *Grabb*, 205 F.Supp. 574 (D.C. Pa. 1962). A 6% interest rate for the use of said funds during a period of soaring interest rates is basically a grant of a benefit to the Petitioner rather than the imposition of a burden.

### 3. The Court below correctly ruled that Petitioner was liable for profits earned by both himself and his wife.

The Petitioner argues that there has been a confiscation of his wife's property because he is being held liable for her profits. He states at page 15 that the judgment:

> "levies against Mrs. McDonough's stock and declares a forfeiture of her profits amounting to $306,000,000."

This is not so.

The judgment below holds Bernard P. McDonough liable for his wife's profits because he was a beneficial owner of her stock and sold that stock and his own in violation of the statute.

In attributing Mrs. McDonough's profits to petitioner for purposes of enforcing Section 16(b), the Courts below have

not taken or confiscated her property. They merely hold petitioner liable for his own and his wife's profits because the statutory policy behind Section 16(b) would be subverted if the enforcing body or trier of facts was required to sift out the realities of transactions between husband and wife.

Obviously as between husband and wife, the opportunities for transmission of inside information and allocation of profits are legion. The Circuit Court pointed out that husband and wife transactions are rife with:

> "the potential of sharp practices" (Appendix B, p. 35).

In the instant case, Mrs. McDonough participated in neither the original purchase nor the negotiations for the "option". Her husband acted on her behalf. He thus "exercised the controlling influence over the purchase, sale and voting of such securities" referred to in SEC release 34-7793, January 19, 1966, 31 F.R. 1005 as a reason for attributing constructive ownership between husband and wife.

Such constructive ownership rules are found in Section 318 of the Internal Revenue Code of 1954, 26 U.S.C. 318, where they implement the statutory policy to ensure that intra-family stock redemptions may not be used as a mechanism to avoid taxes on dividends out of earnings and profits. Proper enforcement of Section 16(b) of the Act in this case requires similar attribution of ownership between husband and wife and the Courts below merely applied the principles enunciated in the SEC Release, *supra*.

The Courts below acted correctly in holding McDonough liable for profits earned in the sale of his wife's shares.

**4. The decision below applied well recognized rules of law to the factual pattern presented by defendant's transaction. There was no unsanctioned departure from established procedure or principles which requires intervention by this Court.**

The Circuit Court (Appendix B, p. 35) discussed the difference between the "objective" versus "pragmatic" approaches and pointed out that this debate was pertinent when the court was faced with transactions which were apparently "sales" but did not risk speculative abuses in insider information and profiteering. However it pointed out that the "pragmatic" approach was never extended to immunize transactions where potential abuses of insider information could be seen and that the "objective" or "rule of thumb" approach would not require a court to disregard the substantive effects of transactions which are "rife with potential sharp practice". The Circuit Court very properly gave the key to the propriety of its ruling:

> "The insider should not be permitted to speculate with impunity merely by varying the paper form of his transactions. The commercial substance of the transaction rather than its form must be considered and courts should guard against sham transactions by which an insider disguises the effective transfer of his stock. *Blau* v. *Allen*, 163 F. Supp. 702, 705, 706 (S.D.N.Y. 1958)." (Appendix B, p. 36.)

The possibility of abuse with respect to options, conversions and similar devices (*Booth* v. *Varian Associates*, 334 F. 2d 1, 3 (1st Circuit 1964), cert. den. 379 U.S. 961) actuated the Circuit Court.

The instant transaction was one in which McDonough effectively rid himself of his and his wife's block of stock and transferred working control of Cudahy. He did not

grant a mere call on the stock. Smelting secured control of Cudahy and had the power to take irrevocable steps with respect to its management and policies. The "option" format could not disguise the realities.

As the Circuit Court put it, the down payment was a "significant deterrent to the abandonment of the contemplated sale" (Appendix B, p. 39). While McDonough and his wife each owned less than 10% of the stock, between them they owned more than 10% of the stock. All of it was purchased in a single transaction and all of it was sold in a single transaction, each negotiated by McDonough himself. The option was spurious. The reality was that McDonough himself transferred the one truly valuable right inherent in his and his wife's stock, namely actual working control of Cudahy. This was accomplished within the six month period prohibited by Section 16(b). The arguments of Petitioner merely reiterate the formalistic aspects of the transaction and disregard its substance completely.

The Courts below penetrated the "option" label and perceived the real nature of the transaction. Their decisions did not strike into new and unfamiliar ground. They furthered this court's teaching in *SEC* v. *National Securities, Inc.*, 393 U.S. 453, 467 that the terms "purchase" and "sale" be construed in a manner which

> "will effectuate the purposes of the specific section of the Act in which they are used." (Appendix B, page 34)

There was no deviation from the accepted and usual course of judicial proceedings below which requires that this Court exercise its power of supervision.

## CONCLUSION

It is respectfully submitted that the Petition for Writ of Certiorari should be denied.

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MELVYN I. WEISS
DAVID J. BERSHAD
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Dated: New York, New York
November, 1970

SECURITIES AND EXCHANGE COMMISSION
Washington, D.C. 20549

Sec 4 11 f 10
2-10-67
55

# FORM 3

## INITIAL STATEMENT OF BENEFICIAL OWNERSHIP OF SECURITIES

Filed pursuant to Section 16(a) of the Securities Exchange Act of 1934, Section 17(a) of the Public Utility Holding Company Act of 1935, or Section 30(f) of the Investment Company Act of 1940.

CUDAHY COMPANY

(Name of listed company, holding company or investment company)

UNITED STATES SMELTING REFINING AND MINING COMPANY

(Name of person whose ownership is reported)

235 East 42nd Street, New York, New York 10017

(Business address of such person; street, city, zone, state)

Relationship of such person to company named above. (See instruction 5) *See Note Below

Date of event which requires the filing of this statement (See instruction 6) July 20, 1967

## SECURITIES BENEFICIALLY OWNED (See instruction 7)

| TITLE OF SECURITY (See instruction 8) | NATURE OF OWNERSHIP (See instruction 9) | AMOUNT OWNED beneficially (See instruction 10) |
|---|---|---|
| Common Stock | *See Note Below | *See Note Below |

* On July 20, 1967 United States Smelting Refining and Mining Company acquired an option to purchase 272,000 shares of common stock of Cudahy Company. The filing of this statement shall not be construed as an admission that United States Smelting Refining and Mining Company is, for the purpose of Section 16 of the Securities Exchange Act of 1934, the beneficial owner of the 272,000 shares of common stock covered by the option.

REMARKS: (See instruction 11)

UNITED STATES SMELTING REFINING AND MINING COMPANY

Date July 20, 1967

by: R. Lawrence George
Signature

# Respondent's Appendix 1

## Securities And Exchange Commission Form 3

## Respondent's Appendix 2

### Excerpt from Deposition of Jack Wilder, President of Smelting

Page 24

Q. When you met with Mr. McDonough in West Virginia on July 20th, was Mrs. McDonough present?

A. We met in his office, and after everything was concluded, we went over to the house, which adjoins the office. And we met Mrs. McDonough there.

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Wilder

Q. Did she participate in any of the business negotiations that took place?

A. No.

## Respondent's Appendix 3

**Excerpt from Proxy Statement of Cudahy dated October 3, 1968 (pages 27-28)**

### Pending Legal Proceedings

Early in 1968, two complaints were filed in the United States District Court for the Southern District of New York against a former Director of Cudahy, Bernard P. McDonough, and against Cudahy as a nominal defendant pursuant to Section 16(b) of the Securities Exchange Act of 1934. Section 16(b) provides that any director, officer or holder of 10% of any class of equity security who purchases and sells within any six month period any equity security issued by the corporation of which he is a director, officer or owner of securities must pay to the corporation any profit which he might have earned by such transactions. The complaints allege that Mr. McDonough purchased (at $6¾ per share) and sold at ($9 per share) 272,000 shares of Cudahy's Common Stock within a six-month period and realized unspecified profits therefrom. Plaintiffs seek, in behalf of Cudahy, recovery of such profits. Although Cudahy is a nominal defendant in the suits, any recovery will be paid to it after deduction of legal fees. The difference between the purchase and sale prices of such shares amounts to $612,000. Upon motion by Mr. McDonough, one of the complaints has been dismissed for jurisdictional reasons, although time for appeal from the dismissal has not yet expired. A ruling upon a similar motion for dismissal on jurisdictional grounds in the second action is being sought by Mr. McDonough.